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SUBJECT: IMF LAUDS ZAMBIA'S ECONOMIC MANAGEMENT, BUT NOTES  
SHORTCOMINGS IN PRIVATE SECTOR DEVELOPMENT

¶1. (SBU) Summary: Zambia's macroeconomic stability is impressive, but the country's environment for private sector development "needs improvement," an International Monetary Fund team told donor representatives on November 1. IMF officials noted that fiscal management was generally good, the kwacha had been more stable in recent months, and the Fund was discussing a range of tax policy issues with the GRZ. Zambia's macroeconomic performance also got good marks from the IMF, but the team noted that Zambia still needed to attain higher levels of economic growth in the longer-run, which required a much more dynamic role for the private sector. End summary.

¶2. (U) Introduction: An IMF mission visited Zambia from mid-October through early November to conduct the fifth review of Zambia's performance under the Poverty Reduction and Growth Facility (PRGF). The mission chief, Francesco Caramazza, briefed donors at the start of the mission and at the mission's end, on November 1. He said that the official written report from the mission should be finalized and available in early January. Highlights of the briefing are provided below.

Fiscal, Monetary Management Good

¶3. (SBU) Caramazza reported that government revenues, which were reportedly well below targets earlier in 2006, were on track or just slightly below targets, as of September 2006, and the expectation by yearend was for revenues to remain on track. Government expenditures were also slightly below the programmed amount for ¶2006. Government financing was consistently above desired targets, but this was due in part to increasing carry-overs from previous years, when spending could not be fully executed due to large cash inflows in short timeframes.

¶4. (SBU) The IMF officials said that the Bank of Zambia's sterilization operations helped to absorb liquidity in the monetary market that resulted from high levels of spending in the August-September 2006 timeframe (the run-up to national elections). These efforts helped reduce kwacha volatility, and have kept the kwacha more stable (in the 3700 to 3900 kwachas to the dollar range). He also advised that a government "megabond" held by the Bank of Zambia would be converted to marketable securities, which would also help to mop up liquidity in the market.

Budget and Tax Issues Under Scrutiny

¶5. (SBU) Caramazza noted that the Fund did not have detailed discussions with the GRZ about the 2007 budget, because a new Cabinet continued to sort out national priorities. He said that the IMF and GRZ agreed on broad outlines for revenues and for domestic financing for the 2007 budget, and that the IMF expects continued fiscal prudence by the GRZ.

¶6. (SBU) Over the past 12 months, the Fund has sent several focused missions to Zambia to address tax issues. Two missions addressed tax policy for the mining sector, one dealt with tax administration and another recent mission looked at broader tax policy issues. The

IMF has prepared and presented a document to the Ministry of Finance and National Planning, which will eventually become available to donors as well. Overall, Caramazza said, the tax system is sound, but one problem the IMF identified was tax exemptions, which are distortionary and effectively pick winners and losers. The tax system should be more predictable, transparent and equitable, he stressed. The GRZ faces the challenge of trying to broaden the tax base while also increasing compliance, effectiveness and efficiency in taxation.

#### Macroeconomic Performance Positive

17. (SBU) For 2006, the Fund expects GDP growth of 6 percent, as a result of continued mining sector expansion, a large investment in a new cement plant, and a strong housing sector. The GRZ also remains committed to meeting inflation targets and expects to achieve an annual rate of 9 percent at year-end. Its medium-term inflation target is 5 percent. One of the longer-term challenges faced by the GRZ is raising levels of growth higher. To do so, the GRZ must give a more prominent role to the private sector and reduce the cost of doing business.

#### Private Sector Development Lags

18. (SBU) Caramazza noted that the GRZ has a good program for private sector development (PSD), but it has been very slow to implement agreed-upon PSD reform measures. For example, the creation of the Zambia Development Agency continues to be hindered by financial difficulties, including ever-increasing costs for retrenchment of officials from the various agencies that will be merged to form the ZDA. In side discussions, IMF officials also acknowledged that the performance of state-owned utilities (particularly for telecommunications and electric power) has been disappointing.

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#### Donors Concerned About Decentralization, Social Spending

19. (SBU) Responding to donor questions about the GRZ's fiscal decentralization efforts, Caramazza noted that although the concept was good, the IMF was concerned about the capacity of local government councils to take on greater financial responsibility, and encouraged the GRZ to build local council capacity before moving ahead with decentralization plans. On the issue of GRZ performance in social sectors, the IMF team noted that the GRZ was making progress in both health and education, particularly in hiring new teachers and health professionals and in improving spending accountability.

110. (SBU) Donors also asked for the IMF's views of the Public Expenditure Management and Financial Accountability (PEMFA) reform program and introduction of an Integrated Financial Management Information System (IFMIS). Caramazza conceded that implementation of these important financial accountability measures has been slow, but he voiced optimism about progress in the next year, based on the strong interest and commitment of the Secretary to the Treasury. The IMF also noted the resource needs identified in the GRZ's Fifth National Development Plan, and the expected gap in donor funding to meet the GRZ's needs. Donors remain concerned about the GRZ's absorptive capacity to manage scaled-up funding, but Caramazza claimed capacity constraints were a "chicken and egg" issue and urged donors to consider providing more resources so that more capacity could be developed.

#### Comment

111. (SBU) We share the IMF's appreciation of Zambia's good macroeconomic management, but remain concerned about the lags in implementing private sector development and financial accountability reforms. Although the delays in the PEMFA programs are largely a result of capacity constraints, the troubles in implementing PSD reforms appear to be more a result of entrenched interests, weak political will, and lack of strong leadership.

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